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FEDERAL POLICIES CONTRIBUTE TO THE SEVERITY OF THE STATE FISCAL CRISIS

By Iris J. Lav

The state fiscal crisis has been deep and prolonged. States have struggled to close deficits that have totaled approximately $190 billion over the past three years. In addition, it is likely that the state fiscal crisis will continue well into state fiscal year 2005 (which, in most states, begins on July 1, 2004). The best estimate at this time is that states will face fiscal year 2005 deficits totaling more than $40 billion.

The major cause of these deficits is flagging state revenues, which are attributable to factors such as lack of employment growth and a weak stock market. But federal policies also have played a significant role, by directly reducing state revenues and imposing additional costs on states. A conservative estimate suggests that federal policies are costing states and localities about $185 billion over the four-year course of the state fiscal crisis, from state fiscal year 2002 through fiscal year 2005. (See Figure 1.)

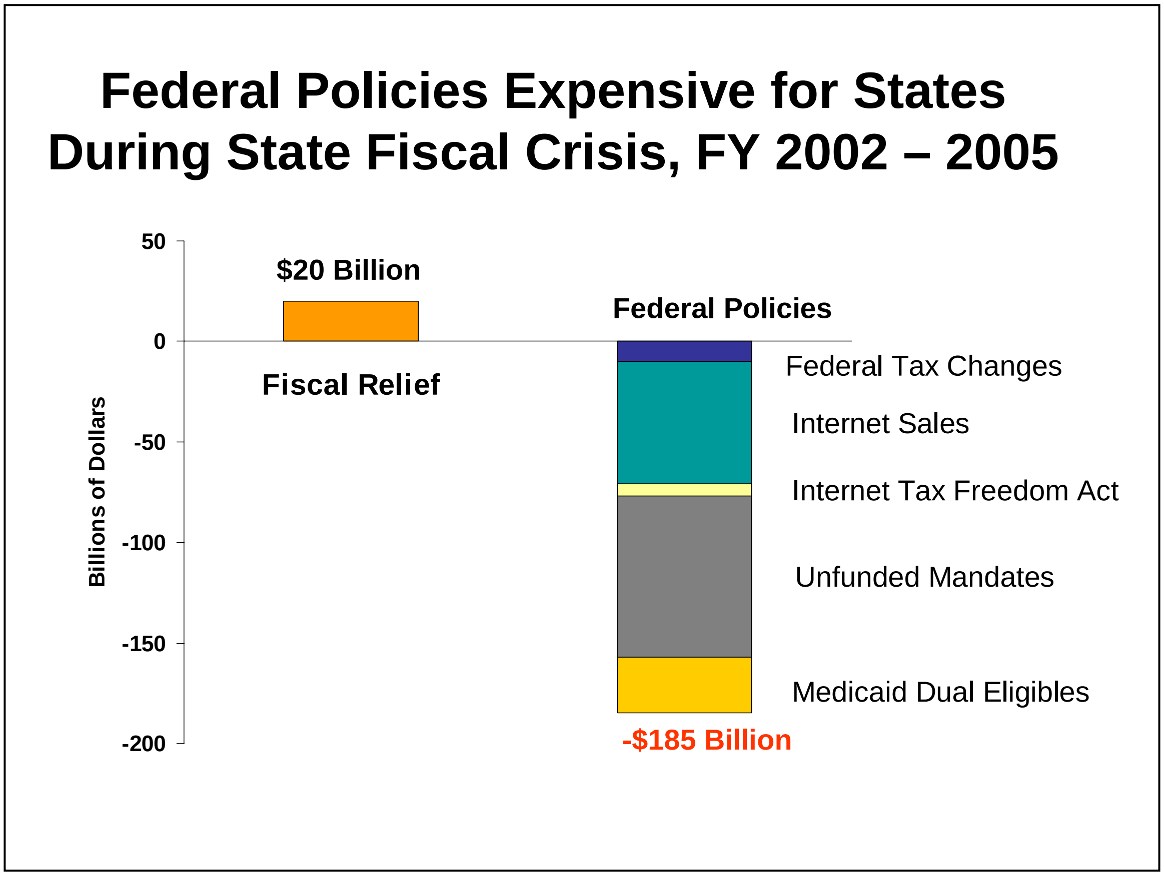
Federal policies are affecting states in a number of ways:

- Some of the federal tax cuts enacted in 2001, 2002 and 2003 are reducing *state* revenues because of linkages between the federal and state tax codes. While some states have "decoupled" their tax systems from these federal tax cuts, others have not been able to do so. The states that have not decoupled are losing approximately $10 billion during the four-year course of the fiscal crisis.

- Federal policies bar states from imposing normal state taxes on certain types of transactions. One example is the federal Internet Tax Freedom Act, first enacted in 1998, which bars states from placing taxes on the access fees that people pay for their Internet service. Just this one preemption of state taxing authority is costing states about $6 billion during the fiscal crisis.

- Two Supreme Court cases prevent state and local governments from collecting sales taxes on most items that their residents buy through catalogs or over the Internet, even though sales taxes apply when the very same items are purchased in retail stores. The Supreme Court noted that Congress has the authority to enact legislation that fixes this problem and enables states that elect to do so to exercise their normal authority to impose sales tax on such purchases. Although federal legislation has recently been introduced to correct this problem, it has not

Figure 1



garnered significant support from Congress or the Administration, and its passage is not expected anytime soon. Research suggests that state and local governments are losing at least $60 billion during the fiscal crisis as a result of the federal government's lack of action to resolve this problem.

- The federal government has placed an assortment of demands and requirements on state and local governments without adequately funding them. These so-called unfunded mandates include requirements in the area of homeland security, election reform, education of disabled children, and the Leave No Child Behind law. The National Conference of State Legislatures has estimated that these unfunded mandates are costing states and localities somewhere between $23 and $82 billion a year. States will spend at least $80 billion meeting unfunded mandates during the four years of the state fiscal crisis.

- Finally, for more than a decade, a growing share of the cost of health care to low-income elderly and disabled people has been shifting from Medicare, which is a federal program, to Medicaid, a program for which states bear an average of 43 percent of the costs. This has occurred largely because changes in medical practice have resulted in shorter hospital stays and increased use of prescription drug therapies. Medicare pays for the bulk of hospital costs for the six million

> low-income elderly and disabled people who are eligible for both Medicare and Medicaid, but it does not generally cover outpatient prescription drugs. Only Medicaid covers prescription drugs. As a result, the changes in medical care that have resulted in shorter hospital stays and increased reliance on prescription drugs have shifted costs from Medicare to Medicaid, and hence from the federal government to the states. States (and the few localities that contribute to Medicaid) are spending about $28 billion in state and local funds during the course of the state fiscal crisis to provide prescription drugs to low-income elderly and disabled beneficiaries who are eligible for both Medicare and Medicaid.

In addition to the negative impact of specific federal policies, there is the question of whether the federal government has taken sufficient action to alleviate the severity of the state fiscal crisis. The federal government is the only level of government that can — and arguably should — run deficits during an economic downturn. It makes sense for the federal government to use this power to run temporary deficits to stimulate the economy when it is weak, and to do so by — along with other steps — providing sufficient temporary fiscal assistance to states to avert some of the more severe types of measures that states have had to institute in the past few years to balance their budgets. Congress did provide $20 billion in fiscal relief to states this spring, and that relief has proved important to states, but it pales in comparison to the size of the problem. If the federal deficit were not mounting at an alarming rate in part because of costly tax cuts heavily geared toward high-income households, the federal government could afford to do more to help states avert substantial cuts in education and health care and significant state tax increases. Such actions by states constitute a drag on the weak economy and also can have decidedly negative human consequences.

Analysis by the Urban Institute-Brookings Tax Policy Center shows that two-thirds of the federal tax cuts being provided this year as a result of the tax-cut measures enacted in 2001 and 2003 are going to households in the top fifth of the population. Moreover, households making over $1 million a year are receiving an average tax cut in 2003 of $113,000 each.[1] At the same time, many states are raising taxes and fees that fall heavily on low- and middle-income families; more than three-fifths of the state revenue raised through tax increases so far during the fiscal crisis has come through hikes in regressive fees and taxes such as sales and excise taxes, which consume a larger share of the income of lower-income households than of more affluent ones. In addition, as described below, states also are cutting back on important services on which many low- and middle-income families rely — cutting child care and health care programs, raising college tuitions, and the like.

The federal government could play a more positive role in alleviating the pain the state fiscal crisis is inflicting. If it does not, the low- and middle-income families that are subject to the state tax increases and service cuts will, in essence, be paying for maintaining the very generous federal tax cuts for the highest-income Americans.

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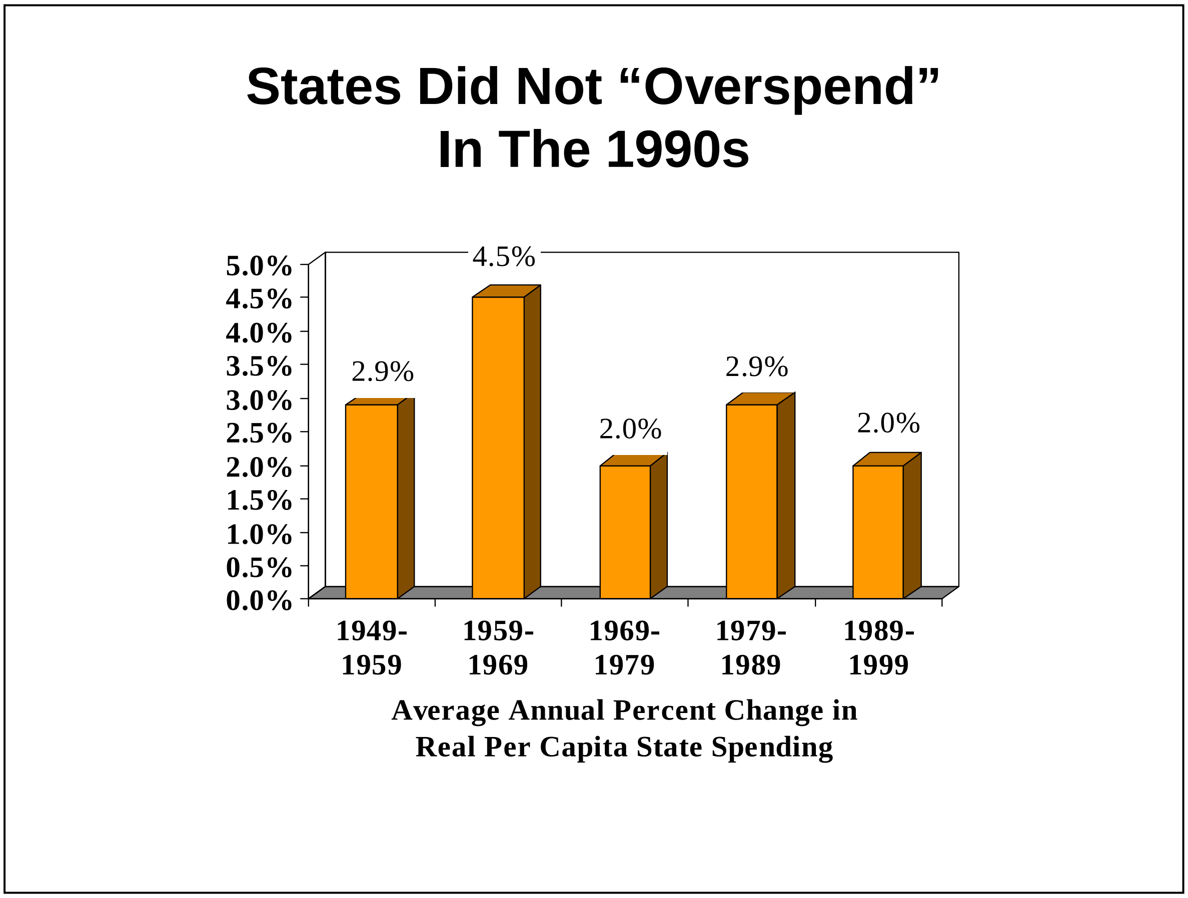
[1] Impact of federal tax changes from Brookings-Urban Tax Policy Center, http://www.taxpolicycenter.org,Table 5.17.

Figure 2



The Fiscal Crisis

States began to fall into fiscal crisis in state fiscal year 2002, when states closed deficits of about $40 billion. Over the next two years, states struggled to close additional deficits totaling approximately $150 billion. Given the continued weakness of state revenues and the extent to which states have either accelerated revenues or postponed expenses to balance the current year's budget, it is highly likely that states will face deficits of at least $40 billion for state fiscal year 2005.

These deficits have *not*, as some assert, stemmed primarily from a state spending spree in the 1990s. State spending growth in the 1990s (adjusted for inflation and population changes), was low by historical standards; it was lower than or equal to spending growth in every other decade since World War II. (See Figure 2.) Furthermore, most of the growth in state spending that did occur during the 1990s was in education, health care, and corrections — areas where costs were rising, need was growing, and/or voters were demanding improvements. *Nine out of ten* new state dollars (adjusted for inflation) went into these three areas.[2]

[2] John Springer, *Did States Spend their Way into this Fiscal Crisis?* Center on Budget and Policy Priorities, August 1, 2003. http://www.cbpp.org/5-9-03sfp3.htm. Liz McNichol, *Fiscal Crisis Is Shrinking State Budgets*, forthcoming.

States also built up their rainy day funds during the 1990s, raising total reserves to their highest level in 20 years. By the end of fiscal year 2000, states had total year-end balances (including both general-fund balances and rainy-day funds) of almost $50 billion, or 10.4 percent of expenditures. Prior to the last recession of the early 1990s, states had total balances of only $12.5 billion, or 4.8 percent of expenditures. As a result, states were better prepared for this economic downturn than they were for the recession of the early 1990s. But those reserves have largely been depleted as a result of the unusually large state revenue declines of the past few years.

State budget cuts have been widespread. Some 18 states cut eligibility for public health insurance for fiscal year 2004 (primarily through cuts in Medicaid and/or the State Children's Health Insurance Program), and 25 states did so for fiscal year 2003. Most of these cuts involved measures to scale back health care coverage for children and parents in families in which the parents work at low-wage jobs. For example, cutbacks in Texas will end coverage under the Children's Health Insurance program for nearly 170,000 children in low-income working families, while Connecticut reduced Medicaid eligibility for parents with incomes between 100 percent and 150 percent of the poverty line, with about 19,000 parents affected. Some 21 states either imposed or began charging higher copayments in fiscal year 2004 for health care services under these programs; the previous year, 17 states added or increased copayments.[3] Research has shown that copayments are a significant deterrent to the use of essential medical care and prescription drugs among the low-income families and individuals whom these programs serve, and that there are adverse health consequences when such treatment is foregone or delayed.

In addition, at least 32 states have cut eligibility for child care subsidies targeted on low- and moderate-income families or otherwise limited such families' access to child care. In 20 states, child care assistance is no longer available to any low-income working families newly applying for such help; such families go on waiting lists instead.[4] At the end of last year, for example, 48,000 children were on the child care waiting list in Florida. Tennessee no longer even accepts child care applications from families not receiving TANF cash assistance. Yet in many cases, a child care subsidy is necessary to make it possible for a low-income parent to work.

Although states usually show great reluctance to cut K-12 education, 11 states instituted cuts for fiscal year 2004, following nine that did so the previous year.[5] This has resulted in the imposition of new or higher fees for textbooks and courses, shorter school days, reduced personnel, reduced transportation, and a variety of other types of cutbacks. States throughout the country also are cutting higher education — leading to double-digit increases in public college and university tuition and significantly reduced course offerings. The tuition increases are creating barriers to higher education for a number of low- and moderate-income families.

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[3] Vernon Smith et. al., *States Respond to Fiscal Pressure: State Medicaid Spending Growth and Cost Containment in Fiscal Years 2003 and 2004. Results From a 50-State Survey*, Kaiser Commission on Medicaid and the Uninsured, September, 2003.

[4] Danielle Ewen and Katherine Hart, *State Budget Cuts Create A Growing Child Care Crisis For Low-Income Working Families*, Children's Defense Fund, March 2003.

[5] National Conference of State Legislatures, State Budget and Tax Actions, 2002 and 2003 preliminary report.

Overall, state general-fund spending, adjusted for inflation and population growth, is estimated to be five percent lower in fiscal year 2004 than it was in 2001.

Causes of the Deficits

While state deficits in the current fiscal crisis are being solved in significant part by budget cuts, they stem primarily from revenue declines. State tax collections for the 12 months ending in June 2003 were about $21.6 billion lower, in nominal terms, than for the same period ending in June 2001, according to quarterly tax collection data from the U.S. Census Bureau. Adjusted for the inflation and population growth, revenues now are nearly $57 billion less than they would be if this decline had not occurred.[6]

In part, the revenue declines result from the weak economy. Until employment recovers and begins to grow strongly and the stock market begins to rise significantly, state finances will remain weak.

State deficits also result in part from overexuberant tax cutting in the 1990s. As at the federal level, state tax cuts were based on the assumption that good times would roll forever — that the unusual and, as it turned out, unsustainable level of revenue growth experienced in the 1990s would continue uninterrupted into the future. Like the federal tax cuts, these state tax cuts have become unaffordable.

Unlike the federal government, some states have effectively reversed some of these tax cuts by raising taxes and other revenues during the downturn. The tax increases of the past two years have offset about half of the annual revenue loss from the state tax cuts enacted in the 1990s. These tax increases have fallen heavily on low- and moderate-income families, however, while the tax cuts of the 1990s tended to confer their greatest benefits on higher-income households.[7]

Still another cause of state deficits is federal policy. There are a number of ways in which federal policies have made the state fiscal crisis deeper and more prolonged. These include specific federal policies that have: a) reduced state revenue directly; b) prevented states from raising revenue; c) reduced funding for programs that states and localities operate; and d) imposed new costs on states. In addition, the federal government has made the fiscal crisis deeper and more prolonged by failing to provide sufficient temporary assistance during the current economic slump. Although the $20 billion in federal fiscal relief provided earlier this year has certainly helped to avert some severe budget cuts, particularly in Medicaid, the federal government could have helped states avert more of the damaging budget cuts and regressive tax increases they have been forced to institute.

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[6] Nicholas Johnson, Jennifer Schiess, and Joseph Llobrera, *State Revenues Have Fallen Dramatically*, forthcoming.

[7] Ibid.

Federal Policies Reduce State Revenue

A number of provisions in the three federal tax cuts enacted in 2001, 2002, and 2003 have reduced state as well as federal revenues, because state tax systems are tied to the federal tax code in a number of ways. One such federal tax cut is the phase-out over four years (2002 – 2005) of the federal estate tax credit that reduces the federal estate tax by a dollar for each dollar paid in *state* estate taxes. Every state in the nation levied a state estate tax that was tied to this federal credit, with most states laws simply setting their own estate tax at a level equal to the federal tax credit. As a result, the change in federal tax law that is eliminating the federal credit is effectively eliminating state estate taxes. Some 18 states and the District of Columbia have managed to "decouple" their estate taxes from this change in federal law and thereby to maintain their own estate taxes. But the remaining states stand to lose $6 billion through fiscal year 2005 and $14 billion through fiscal year 2007.

Another federal tax cut that is causing states to lose state revenue is a business tax cut known as "bonus depreciation." As originally enacted in 2002, the federal "bonus depreciation" tax cut allowed businesses to deduct immediately 30 percent of the cost of equipment they purchase, rather than writing off the cost of the equipment in a more even manner over the equipment's useful life (i.e., over a number of years). Most states tie their depreciation tax rules to the federal depreciation rules. As a result, they would have experienced a revenue loss totaling approximately $14 billion over the period from 2002 through September 2004 (the period over which the federal depreciation tax cut was initially slated to be in effect). The majority of states, however, were reluctant to piggyback on to this temporary federal tax cut during a period when state revenues were declining, and 31 states have "decoupled" and maintained their prior tax treatment of depreciation rather than adopting the new, very generous federal provision.

In 2003, Congress and the Administration made the federal depreciation tax cut even more generous, allowing firms to deduct immediately 5*0 percent* of the cost of equipment they purchase and extending this tax cut through December 2004. This is resulting in further state revenue losses in those states that have not decoupled from this federal tax cut. The non-decoupled states are losing approximately $4 billion through fiscal year 2005. They will lose still more if Congress extends this tax cut beyond the end of 2004, as now seems likely.[8]

Federal policies also have prevented states from raising revenues in a number of areas. The Internet Tax Freedom Act, which the U.S. House of Representatives recently voted to expand and make permanent, bars states from collecting taxes on Internet access fees. These access fees are the $25 to $50-a-month charges that Internet users pay to companies such as AOL for their Internet accounts.

This ban is costing states approximately $1.7 billion a year, or more than $6 billion over the four years of the state fiscal crisis from state fiscal year 2002 through 2005. Furthermore, the legislation that the House of Representatives recently passed and that is pending in the Senate would expand the types of Internet-related services that states are barred from taxing, thereby

[8] Nicholas Johnson, *Federal Tax Changes Likely to Cost States Billion of Dollars in Coming Years*, June 5, 2003. http://www.cbpp.org/6-3-03sfp.htm

reducing state revenues to a much greater extent. The Multistate Tax Commission, a joint agency of state governments, estimates that the recently passed House legislation could cost states and localities an additional $4 billion to $8.75 billion a year by 2006.

Still another example is the failure of the federal government to act to empower states to collect sales taxes on items purchased over the Internet and through catalogs. When a person buys a product in a state, he or she pays sales tax at the time of purchase. If the person buys the same item over the Internet or from a catalog, however, the state generally cannot compel the out-of-state seller to collect and remit the sales tax to the state. This is because two Supreme Court decisions have barred states from requiring sales taxes to be remitted when the vendor does not have a physical presence in the state. This hurts small businesses and in-state retailers, which become less competitive with Internet and catalogue sellers, and also prevents states and localities from collecting significant amounts of revenue that otherwise would be due to them.

One of the Supreme Court decisions, the 1992 *Quill* decision, made clear that Congress *can* pass legislation to empower states to tax sales made to state residents by vendors not physically present in the state. Legislation has been introduced to this end in almost every session of Congress, but it has consistently been blocked by a coalition of federal legislators who refuse to help state and local governments raise revenue in this manner, whether out of general anti-tax ideology or in response to strong pressure from the politically-potent direct marketing and electronic commerce industries. In the past, an argument against federal action to enable states to collect sales tax on catalog and Internet sales has been that as a result of differences among state sales tax systems, a requirement to collect and remit sales tax would impose too great a burden on the out-of-state vendors. In the last few years, however, states have made substantial progress under their "Streamlined Sales Tax Project" in harmonizing state sales tax systems in ways that will substantially reduce the burden of collecting these sales taxes. The time thus is ripe for Congress to enact a solution to this problem and thereby to stem what threatens to become a hemorrhage of state and local revenues. So far, Congress shows no sign of doing so.

Donald Bruce and William Fox of the University of Tennessee estimate that inability to collect tax on Internet purchases is costing states and localities about $35 billion this year in lost revenue.[9] During the fiscal year 2002 through 2005 period — i.e., during the state fiscal crisis — the estimated revenue loss is a total of $121 billion. It is unclear how much of this amount could actually be collected by the states under a politically feasible solution to this problem. At the minimum, states would have to provide some compensation to vendors for collecting the tax, and there would have to be some exemptions from the requirement of collecting the tax to protect small vendors. A conservative estimate is that the failure of the federal government to resolve this problem is costing states at least $60 billion over the four-year course of the state fiscal crisis.

[9] Donald Bruce and William F. Fox, "*State and Local Sales Tax Revenue Losses from E-commerce: Updated Estimates,*" September 2001.

Beyond the Internet Tax Freedom Act and the E-commerce problem, there are many other examples of federal preemption of state tax bases, although the other examples tend to be harder to quantify.[10]

Federal Policies Increase State Costs

Over time, the federal government has placed an assortment of demands and requirements on state and local governments without adequately funding these requirements. These so-called unfunded mandates include requirements in the area of homeland security, election reform, the education of disabled children (IDEA), and the Leave No Child Behind law.

- Homeland security includes emergency management and assistance, disaster relief, counterterrorism, public safety and first responder training, smallpox inoculation, public health, safeguarding the safety of the water supply, strengthening food and agricultural security, and upgrading communications. The National Conference of State Legislatures estimates that federal funding for homeland security activities falls short of state costs by about $6.5 billion to $17.5 billion this year.

- The Individuals with Disabilities Education Act, enacted in 1975, was most recently amended in 1997. It guarantees each disabled child an assessment and an individualized education plan. When the law was enacted, the federal government promised it would fund 40 percent of the additional costs that the law requires states to incur. Funding to bring the federal share to 40 percent, however, has never materialized. According to NCSL, additional federal funding of $11 billion a year would be needed for the federal government to reach its 40 percent share of the expenditures that state governments are compelled to provide.

- The “No Child Left Behind Act” requires schools to take a variety of specific steps with respect to the testing of children. It also prescribes various remedies for schools in which test scores do not meet standards, including giving children the right to transfer to another school, even if providing that alternative would be costly. It is unclear how much it will cost states and localities to meet the mandates in this new law. NCSL suggests that the unfunded costs are likely to be in the range of $5 billion to $35 billion a year.

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[10] For example, federal law prohibits state and local governments from taxing airline and bus tickets purchased for interstate travel. Were states able to apply their sales taxes to such tickets, the revenue gain would be large. Federal law also prohibits states and localities from taxing the income of certain out-of-state corporations. P.L. 86-272 provides that neither a state nor its subdivisions can impose a corporate profits tax on an out-of-state corporation if the corporation’s only activity within the state is soliciting orders for physical goods, provided the orders are approved at an out-of-state office of the seller and the goods are shipped into the state from an out-of-state location. This allows corporations to have an unlimited number of salespeople in a state at all times, yet remain exempt from tax so long as the salespeople work out of their homes. When P.L. 86-272 was enacted in 1959, it was intended to be temporary. However, it has never been repealed, and over the years, it has shielded tremendous amounts of corporate profits from state taxation.

TABLE 1

CURRENT LEVELS OF SELECTED UNFUNDED MANDATES AND UNDERFUNDED NATIONAL EXPECTATIONS IMPOSED ON STATE AND LOCAL GOVERNMENTS

(As of April 16, 2003)

IDEA – SPECIAL EDUCATION	$11 billion - $25 billion
NO CHILD LEFT BEHIND	$5 billion - $35 billion
ELECTION REFORM	$1 billion - $5 billion
HOMELAND SECURITY	$6.5 billion - $17.5 billion
TOTAL	$23.5 billion - $82.5 billion

In the past, the federal government has often placed mandates on states and localities without providing adequate funding to meet those mandates. Recently, the confluence of the state fiscal crisis and both new and old mandates has made it more difficult for state and local governments to meet these requirements. The new mandates relating to homeland security became expensive just as the state fiscal crisis was deepening. In addition, the new federal requirements related to the No Child Left Behind Act are growing in cost now, at a time when states have few resources to cover these new costs. The new costs are on top of the ongoing costs of special education for children with disabilities, for which the federal government has never met its promise to pay 40 percent of the tab.

The National Conference of State Legislatures has estimated that these unfunded mandates together are costing states and localities somewhere between $23 and $82 billion a year.[11] Looking at the four-year period of the state fiscal crisis, a conservative estimate is that states have spent a total of at least $80 billion meeting unfunded mandates.

Rising State Medicaid Costs: The Federal Role

Another issue is Medicaid. Much has been made of the rate of growth of Medicaid costs, which reflects, in large part, the rapid growth of health care costs in the economy generally. However, a portion of the growth in state Medicaid costs is due to another factor: a gradual shift in the cost of caring for low-income elderly and disabled people from the federal government to the states. Over the last several years, an increasing share of the cost of health care for low-

[11] National Conference of State Legislatures. "Current Levels of Selected Unfunded Mandates and Underfunded National Expectations Imposed on State and Local Governments (as of April 16, 2003). http://www.ncsl.org/standcomm/scbudg/budgmandates03.htm

income elderly and disabled people who are enrolled in both Medicare and Medicaid has been shifting from Medicare, a federal program, to Medicaid, a program in which states bear an average of 43 percent of the costs. This has occurred in part because the duration of hospital stays has decreased while the use of pharmaceuticals to manage health conditions has increased. For beneficiaries covered by both Medicare and Medicaid, the Medicare program is the primary paper for hospital stays. By contrast, Medicare does not generally cover outpatient prescription drugs; only Medicaid does. (Medicaid also is the only payer for long-term care.)

As a result, when shifts in the provision of health care lead to shorter hospital stays and greater reliance on pharmaceutical therapies, costs shift from the federal Medicare program to the federal/state Medicaid program, and hence from the federal government to the states. This shift is quite significant, since at least 35 percent of all Medicaid expenditures are made on behalf of low-income elderly and disabled individuals who are enrolled in both Medicare and Medicaid. The cost to states for outpatient prescription drugs for this population is approximately $28 billion over the four-year fiscal crisis period.[12]

The House and Senate each have recently passed legislation to cover prescription drugs under Medicare. Under the Senate version of the Medicare prescription drug benefit (S.1), however, the "dual eligibles" — the low-income elderly and disabled beneficiaries enrolled in both Medicare and Medicaid — would be *ineligible* for the new Medicare prescription drug benefit. The six million low-income seniors and people with disabilities enrolled in both programs would continue to be able to get prescription drug benefits only through Medicaid. This would represent the first time in Medicare's history that a group of Medicare beneficiaries has been excluded from a Medicare benefit, in contradiction to the longstanding principle that Medicare benefits should be universally available to all Medicare beneficiaries. The prescription bill that the House of Representatives passed charts a different course, making the "dual eligibles" eligible for the new Medicare drug benefit.

Since many state Medicaid programs place various restrictions on drug coverage, excluding these low-income beneficiaries from the Medicare drug benefit (and continuing to require them to get drug coverage solely through Medicaid) would mean that many Medicare beneficiaries with low incomes would receive skimpier government-subsidized drug coverage than Medicare beneficiaries who had higher incomes. It also would mean that states would have to continue bearing a sizeable share of the costs of providing prescription drugs to many of the nation's neediest elderly and disabled citizens. All 50 of the nation's governors have said that including the "dual eligibles" under the Medicare drug benefit is the top state priority related to the prescription drug legislation.

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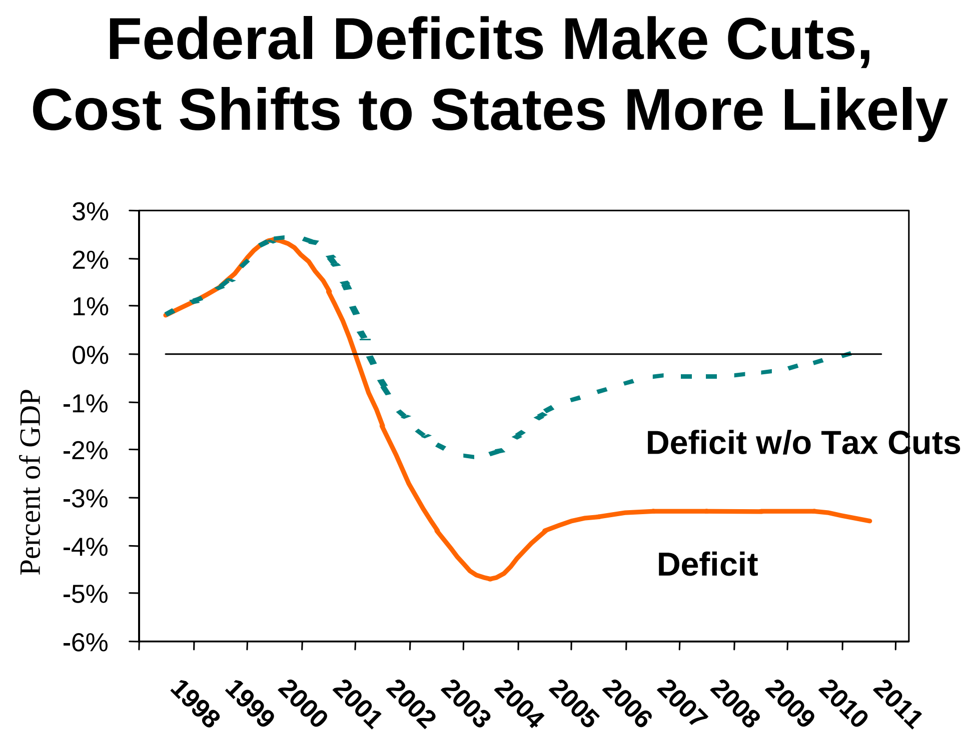
[12] The cost to states of prescription drugs for the dual eligibles begins with an estimate prepared for the Commonwealth Fund by Stacy Dale and James Verdier of the costs of covering this population in federal fiscal year 2002. We adjust that estimate to take into account manufacturer rebates paid to states under the Medicaid Drug Rebate Program, which are estimated to reduce state drug expenditures by 18 percent. The estimate for fiscal year 2002 is then projected for the four-year period of the fiscal crisis by adjusting the fiscal year 2002 estimate for Medicaid prescription drug inflation, as estimated by the Congressional Budget Office in its March 2003 baseline.

Figure 3



Deficit projection is a "likely path." It includes extension of the tax cuts, AMT relief, a prescription drug benefit, and realistic defense spending.

The Cost to States of Federal Policies

The federal policies discussed above are costing states at least $185 billion over the four-year period of the state fiscal crisis, from state fiscal year 2002 through 2005. Nor are these policies the full story. As the federal tax cuts begin to squeeze the rest of the federal budget to a greater degree in the years ahead, federal funding for grants to states for purposes other than Medicaid is likely to decline. Under the budget path laid out in the President's budget, which is similar to the path in this year's Congressional Budget Resolution, the total buying power of federal grants to states and localities for purposes other than Medicaid — including grants for education, transportation, environmental protection, and other program areas — would be reduced by a cumulative total of $33 billion over the next three years. This will hamper the ability of states and localities to recover from the fiscal crisis.

Federal Policies Could Help

As federal budgets are written for the next several years, many programs are likely to be squeezed. The federal tax cuts enacted in the past three years have added substantially to the federal budget deficit. So have increases in defense spending, the decline in the economy, and other factors. The deficit is now expected to exceed $500 billion in fiscal year 2004. If the tax cuts are extended and other anticipated policies (including a prescription drug benefit) are implemented, federal deficits are expected to remain above $400 billion every year in the coming decade and to total approximately $5 trillion over the decade.[13] (See Figure 3.)

The tax cuts will cost $275 billion in 2004 alone, of which $85 billion — about the same amount as the pending funding request for Iraq and Afghanistan — will go to the one percent of Americans with the highest incomes. These high budget deficits increasingly will constrain the ability of the federal government to fund other priorities, including grants-in-aid to states.

While the $20 billion in federal fiscal relief that was enacted in mid-2003 has been very helpful in averting some damaging state budget cuts, this amount falls far short of the relief that the federal government could — and should — be providing to states during the current period of economic sluggishness and state fiscal crisis. Many economists and budget experts have called over the past year or two for the federal government to provide $40 billion or $50 billion in such relief. Even that larger amount is modest relative to the size of the state fiscal crisis and the costs that federal policies are imposing on states.

Most states are required to balance their operating budgets even in economic downturns. The budget cuts and tax increases they enact during such times pull money out of the economy, thereby slowing the economy even more and causing a loss of jobs.

Only the federal government can remedy this problem. It need not balance its budget in a recession; it can run deficits. (Running large persistent federal budget deficits when the economy is healthy can ultimately harm the economy, but running deficits during economic slumps is helpful. It puts more money into the economy and stimulates it.) It therefore makes sense for the federal government to provide significant fiscal relief to states when the economy is weak.

It also makes sense for the federal government to assist states to a greater degree with the cost of providing health care to lower-income elderly and disabled people and thereby to cushion the fiscal effects of the recent changes in health care practice that have shifted costs from the federal government to the states. And it makes sense for the federal government to fund more adequately the mandates it imposes on state and local governments and to resolve the problems associated with federal preemption of state tax bases. With the exception of the preemption issues, addressing these matters would require federal funds.

There thus is a choice for federal policymakers. It is a choice between maintaining in full the extremely generous federal tax cuts for high-income households or moderating those tax cuts and instituting more equitable policies toward the states that help state and local governments to preserve important endeavors in areas such as health care, child care, and education — areas on which low- and middle-income state residents rely — and avert regressive tax and fee increases. At bottom, this is a question of which course represents the higher priority for the nation.

[13] Center on Budget and Policy Priorities, Committee for Economic Development, and Concord Coalition, *Mid-Term and Long-Term Deficit Projections*, September 29, 2003. http://www.cbpp.org/9-29-03bud.pdf